PALOS
INVESTMENT FUNDS

February 22, 2013

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Palos Weekly Commentary

■ Palos Income Fund
By Charles Marleau

An IPO Champion

On February 2, 2013 Palos wrote about an initial public offering (IPO) for a company called American Hotel Income Properties (TSX: HOT-U). Palos participated in the IPO, and the new issue started trading on February 20th, 2013. Out of the gate HOT-U traded at a slight premium to its issue price. Palos took the opportunity to accumulate more at those levels. By Friday, February 22, 2013, HOT-U was up 6% from issue price. We are pleased to see HOT-U performing well, however we feel there is plenty more upside. Our rationale is purely based on fundamentals: HOT-U is still trading at a very attractive multiple, has a relatively low payout ratio, relatively high yield, and very attractive cap rate metrics. Palos sees HOT-U trading up as its cap rate falls to levels closer to that of its peers. We would not be surprised to see the stock at $13.00 by year end and all the while clipping a 9% (based on the IPO price) dividend along the way.

■ Risks, Hedges and Opportunities
By Adam Smalley

Cheap Chemicals

Consistent with our theme of increasing exposure to US assets and the USD, we established a position in Lyondell Chemical (NYSE: LYB) this week. Lyondell is a specialty chemical company that produces chemicals, fuels and polymers used in all sorts of industrial applications, including building products. Palos has known Lyondell for a long time, having participated in various debt offerings over the years.

Lyondell fits firmly into our theme of investing

Chart 1: Palos Domestic Funds*

	FundServ	NAVPS	5D Returns	YTD Returns
Palos Income Fund L.P.	PAL 100	CA $9.14	0.06%	4.34%
Palos Equity Income Fund - RRSP	PAL 101	CA $7.02	0.00%	2.96%
Palos Merchant Fund L.P. (Jan 31, 2013)	PAL 500	CA $8.41	---	2.82%
Palos Majestic Commodity Fund L.P. (Feb 21, 2013)	PAL 600	CA $11.04	-1.42%	4.02%

Chart 2: Market Data*

	Value	5D Returns	YTD Returns
S&P TSX Total Return Index	36,576.06	0.15%	2.46%
S&P 500 Total Return Index	2,670.36	-0.22%	6.62%
S&P TSX Venture Index	1,144.68	-3.46%	-6.25%
MSCI All Countries World TR Index (CAD)	3,549.20	0.15%	6.60%
US Government 10-Year	1.96%	-0.04%	0.20%
Canadian Government 10-Year	1.94%	-0.07%	0.15%
Crude Oil Spot	US $93.13	-$2.73	$1.31
Gold Spot	US $1,572.40	-$36.40	-$103.40
US Gov't10-Year/Moody BAA Corp. Spread	193 bps	3 bps	2 bps
USD/CAD Exchange Rate Spot	US $0.9791	-$0.0146	-$0.0261

* Period ending Feb 22, 2013

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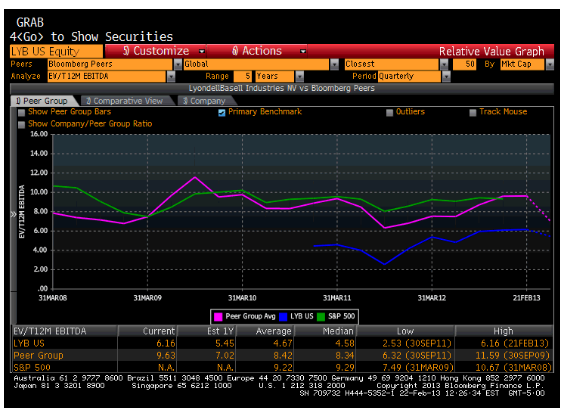
in US companies that will benefit from an improvement in housing and general industrial activity. Moreover, natural gas is one of Lyondell's main feedstocks and the drop in natural gas has provided over $100 million in additional EBITDA to Lyondell in each of the past few years. We expect that this "built in" competitive advantage will continue.

Lyondell recently reported a strong quarter and announced that it was buying back up to 10% of its common shares. Lyondell currently pays a 2.7% dividend and has a history of paying special dividends ($2.75 in October 2012 and $4.50 in November 2011).

The graph below compares trading multiples (measured by enterprise value to EBITDA) for Lyondell (in blue), its industry peers (in pink) and the overall S&P 500 (in green). Lyondell compares favorably, increasing our confidence in the stock.



EV/T12M EBITDA	Current	Est 1Y	Average	Median	Low	High
LYB US	6.16	5.45	4.67	4.58	2.53 (30SEP11)	6.16 (21FEB13)
Peer Group	9.63	7.02	8.42	8.34	6.32 (30SEP11)	11.59 (30SEP09)
S&P 500	N.A.	N.A.	9.22	9.29	7.49 (31MAR09)	10.67 (31MAR08)

Lyondell stock ended the week at $59.32, still 15% lower than the consensus 1-year price target of $70.17. The Palos funds bought Lyondell on Thursday at $57.50 in the midst of the stock sell-off.

■ What is New on the Macro Level?

By Hubert Marleau

What is Going on with Gold?

The history of discretionary monetary policy is one catastrophe after another, and the gold market loves it. Central banks have invented several rules and targets to replace the gold standard because they are aware that an economy works better under stability protected by an anchored standard. Since 1985, central banks have managed monetary policy with either money growth and interest rate rules or inflation and unemployment rate targets. Gold perma-bulls argue that rules and targets are not firm enough to ensure price stability. In other words, the economic system has an inherent inflationary bias because governments indirectly or otherwise have tendencies to intervene one way or another with the monetary order, manipulate the public and trick investors. I believe in the above proposition that government does what it can, on the quiet, to influence the conduct of monetary policy especially when the going is tough. Since 1999 economic tensions have been high and monetary policy, for the most part, has been very loose. In the twelve months ended July 2011, the price of gold increased about 7.5 fold to reach $1900 per troy ounce. In essence, gold price, as the theory promised, tracked closely the growing abundance of money and the declining path of real interest rates. However, it appears that gold prices may have run-up too fast and too far.

1) A recent technical view by Oppenheimer opines that gold, having essentially tripled in price in the past five years, is toying with the prospects of violating the uptrend line that has been in effect since the $700 low in 2008.

2) A recent research paper by Credit Suisse ascertains that the price of gold has never been as high as it is today, in real terms, for this long. The long-term real average price of gold in 2007 US dollars since 1841 is $462 per ounce. Since the end of dollar convertibility in 1971, it is $653.

3) A recent study by Duke University shows that the world stock of gold, estimated at 171,300 metric tons, is currently worth about $9.0 trillion. In 1999, the world stock of gold totalled about 145,000 metric tons for a value of $1.5 trillion. This is equivalent to a 6.0 fold increase in the value of the world stock of gold. During the same 12 years, The US money stock (MZM) expanded from $4.0 trillion to $12.0 trillion for much lesser 3.0 fold increase.

4) As a matter of fact, in relative terms to industrial metals, energy, housing and equities, the price of gold is definitely expansive and has been so for some time.

What is fair value for gold is difficult to discover and, therefore, a matter of debate. Put simply, the "reflation fix" of central banks combined with "rolling financial issues" since the collapse of Lehman Brothers have been the main drivers behind the rising price of gold and treasuries. Credit Suisse argues that extreme fears that have

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characterized the world scene since 2008 are dissipating. The bank's research desk has put forth that the peak in fear trades occurred last July. The point of inflection took place when the ECB President Mario Draghi firmly committed that the ECB would do "whatever it takes" to save the euro. If this is true, the remaining concerns have to be with what will happen to real rates and the excess reserves at the Fed. Firstly, the day is approaching for a change in the Fed's monetary stance. The inflation composition of the misery index (9.6) is rising and currently stands at 18%. At 25% is when the turn will come. In a previous weekly letter, I argued this point. Real rates are still negative but they are slowly moving up. Secondly, it is possible that bank excess reserves may never be monetized. Prudent management, regulatory restrictions and investor aversion to risk are forcing banks to keep higher liquidity and capital-to-assets ratios. In effect, excess bank reserves are unofficially frozen. Accordingly, the Federal Reserve Banks could just decide to raise the reserve requirement to a level that would officially absorb all or part of the excess bank reserves. It should be noted that when the Fed balance sheet increased some $2.5 trillion in the two years following the sub-prime crisis, the price of gold shot up $700. In this connection, one could arguably defend the proposition that the $700 is fluff. In this connection, gold prices could trend lower to $1200.

The TSX index has 8% exposure to gold compared to Palos Income Fund which has approximately 1% gold exposure, primarily through Goldcorp (TSX: G). Goldcorp, in the opinion of the Palos portfolio managers, is the most attractive gold stock to own. It has relatively low lifting costs, is producing significant cash flow, and is located in favorable jurisdictions.

Sources:
Brief History of the Gold Standard in the United States, CRS Report for Congress
Gold: The Beginning of the End of an Era, Credit Suisse
The Golden Dilemma, Duke University

■ Date limite des REER / RRSP Deadline

Pour faire une cotisation à votre REER déductible pour l'année d'imposition 2012, les chèques doivent parvenir à Palos avant la fin du février 2013 de manière à ce qu'ils soient traités avant le 1er mars 2013.

Veuillez noter qu'il n'y a aucune date limite pour faire une cotisation à un CELI.

Pour ouvrir ou cotiser à un REER ou un CELI, veuillez communiquer avec Alexandra Kaneb au 514-397-0188 poste 228 ou par courriel à l'adresse akaneb@palosmanagement.com.

N'hésitez pas à prendre rendez-vous avec nous pour discuter des placements que vous détenez chez Palos.

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Please note the deadline is quickly approaching for 2012 RRSP contributions. Checks should be received by Palos before the end of February for processing before March 1, 2013.

We can continue to accept TFSA contributions throughout the year.

If you would like to contribute to or open an RRSP or TFSA account, please contact Alexandra Kaneb at 514-397-0188 extension 228, or by email at akaneb@palosmanagement.com.

We welcome you to make an appointment with us to discuss your Palos investments.

If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at info@palosmanagement.com

Chart 3: Palos International Fund**

	Last	5D Returns	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA $5.23	0.73%	3.21%
Palos International Equity Income Fund PLC - EUR	EUR 6.79	0.60%	-0.20%
Palos International Equity Income Fund PLC - USD	US $6.60	-0.21%	0.83%
S&P TSX Composite Total Return Index - CAD	36,878.64	0.21%	3.31%
S&P TSX Composite Total Return Index - USD	36,416.16	-0.81%	1.50%

** Period ending Feb 19, 2013